The collapse in the European price of emissions permits has led to wide spread claims that markets don’t work and that the Australian government was wrong to link our emissions trading scheme with the European ETS. Neither conclusion is right, but that doesn’t mean we should just carry on. Carbon markets can work, but only if they are credible and politicians are committed to them for the long term.

Overnight, the European Parliament rejected a plan to boost the permit price of the EU’s carbon trading scheme. The plan would have “backloaded” permits – preventing them from being used until later – in the hope that the move would push permit prices above their recent level of €5 per tonne. When the plan was rejected, major British newspapers such as the Guardian and the Times talked of a monumental failure that left the emissions trading scheme in tatters.

That is too harsh. Certainly the planned intervention would have been a failure – and so it should have been. It was almost exactly the wrong sort of intervention in a market and would have only increased investor uncertainty.

Since its establishment in 2005, the European ETS has evolved to work well as a market. The collapse in price, claimed by some to represent a market failure, was rather an efficient market response to a collapse in demand for permits. Demand has fallen because of flaws in the implementation of the ETS – an excess of allocated permits in earlier periods – but, more importantly, because reduced economic activity in Europe has reduced emissions.

As emissions have fallen, so has the price of permits, which is exactly as it should do in a free market. If and when economic activity increases, the ETS will respond just as efficiently in the other direction: prices will rise. Claims of market failure can usually be traced either to those with a commercial interest in technologies which need a higher carbon price, or to those who would like to see the back of climate change policies in any form.

But while the market is working, the politics behind it are a different matter. The current low carbon price should be seen as an opportunity to produce more ambitious long-term targets for emissions reduction that underpin the long-term demand for permits. The targets must be tightened in a predictable way but if they are not, in Europe and elsewhere, the agreed objective of keeping average global temperature increases to less than two degrees centigrade will not be met.

Once the market sees that governments are committed to the progressive tightening of targets, the price of carbon will rise accordingly. Investors in low-carbon technologies will begin to gain the confidence that they currently lack; confidence that is even more reduced by ad hoc interventions whenever the market delivers price outcomes that some find unpalatable.

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The move to link the Australian ETS to the EU scheme from 2015 is an important step in the development of a global patchwork quilt of policies that might continue to tackle climate change in a period when there is no likelihood of a global commitment to binding targets any time soon. Developing interconnected policies around the globe matters because, as many critics point out, unilateral action on climate change would be both ineffective and costly.

But linking the two schemes brings problems. One arises from the Australian government’s decision to begin the ETS with a fixed price, starting at $23 per tonne and rising to $25.40 for 2014-15, after which the market will set the price. That would have aligned our scheme with Europe’s when, in 2011, there were plausible projections that the European price would be close to $29 by 2016. Australia also chose a fixed price to provide some level of stability and predictability.

The problem was that a price fixed on a market projection was always likely to be wrong. We now see that the Australian carbon price could collapse from $25 to less than $10 in 2015. This is hardly the stability the scheme needs. The prospect of such a price collapse has triggered calls for change from both sides of the climate change debate. Those who would benefit from a sustained, higher price to underpin their low-carbon investments or see a higher price as measure of climate change success want the government to intervene to protect the price. Those whose interests are against higher carbon prices are calling for an even earlier linkage to the European ETS, now that its price has collapsed.

The latter proposal has merit, even if it is partly based on self interest. It is possible that further moves in Europe – ideally in the direction proposed above – could cause the price to rise again. But economic forces or political reluctance to act could impede such action. Either way, Australia should still link with the European scheme, and other robust schemes as they are developed.

The dilemmas described above arise from the way both the European and Australian schemes have been implemented, rather than from the market mechanism itself. In both places the best solution is to steadfastly move towards a carbon price that starts low and rises steadily and predictably. The schemes will be credible when governments refrain from ad hoc interventions that destroy market confidence and don’t work anyway.

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